

of the calculations, that is, the costs that are calculated prior to point of the Total Company costs. Most of the LECs provide some detail once the Total Company values are presented, for example the derivation of the non-regulated quantities, the total subject to separations, the allocation to interstate and ultimately to the Part 69 rate elements. However, neither MCI, nor any other interested party, would be able to use the information provided to ascertain whether the total SFAS-106 costs are appropriate. The parties simply have not provided an adequate level of detail on their calculations, nor have they provided comparable formats, to ascertain whether the level of expense is appropriate within companies or across companies.

For example, little, if any, detail is provided which shows the amounts that each company has calculated for either the transitional obligation or the current year obligation. As selected examples: GTE provides a one sentence summary of its SFAS-106 costs for 1993; NYNEX shows one table in Attachment B of its Direct Case which summarizes in a highly aggregated form the interstate SFAS-106 costs; Pacific, contrary to many of the other LECs, provides some level of detail as to its transitional and current year obligations in a series of worksheets in Appendix 2; BellSouth offers the same level of detail as NYNEX. Without further detail on the derivation of these costs, MCI cannot comment on whether the amounts are correct. Even the most basic detail, such as the number of employees used in the calculations, is missing.

This situation is particularly grave, since it would impact the ability of the Commission and ratepayers to analyze the subsequent filings that would true-up the SFAS-106 liability. For example, a carrier that has a significant downsizing of its work force

would be required to reduce its SFAS-106 liability and alter its price cap indices to reflect such a change. Without some type of standard exposition of the underlying data, similar to the Tariff Review Plan data that is provided by the LECs to justify their current exogenous costs, parties would be unable to determine whether the changes in costs are just and reasonable. Therefore, the current Direct Cases fall far short of the level of detail required to ascertain the reasonableness of the cost estimates.

¶ 11. (5) all studies on which the LEC seeks to rely in its demonstration that these accounting changes should be considered exogenous cost changes, including all studies demonstrating that the change is not reflected in the current price cap formulas, factors for inflation, productivity, allowed exogenous changes, initial price cap rates, and the sharing and low-end formula adjustment mechanisms;

The filing LECs contend that their supporting studies by USTA and NERA provide all that is needed pertaining to the impact of SFAS-106 costs on the above-requested items. MCI, however, believes that the studies used to justify the exogenous treatment of SFAS-106 costs illustrate quite dramatically the arbitrariness of the price cap LEC arguments for exogenous treatment of SFAS-106 costs and the presumed lack of double counting within the GNP-PI. Two studies are submitted by the LECs, one commissioned by USTA and concurred in by most of the filing LECs. The second, commissioned by PacBell and concurred in by Rochester, was performed by NERA. Both studies suffer from basic faults that essentially preclude their usefulness in gauging the impact of SFAS-106. Even if the Commission were to decide that SFAS-106 costs should be afforded exogenous treatment in a general theoretical sense, neither study can be relied upon to quantify the amount of double counting inherent within the GNP-PI. Moreover, neither study adequately addresses

the simultaneous treatment of wages and benefits, as well as the cost of equity impacts discussed above. Also, the LEC filings provide no meaningful discussion of the role of the low end adjustment within the SFAS-106 proceeding.

THE STUDIES ARE INHERENTLY CONTRADICTORY

The two studies offered by the LECs to support their arguments are based on two dramatically different assumptions regarding the impact of SFAS-106 on the GNP-PI. First, the NERA study makes the sweeping argument that in the unregulated sector prices reflect the economic (accrual) costs of OPEBs, and that therefore, by definition, there will be no impact on the price level from a change to SFAS-106.²⁶ Taking the opposite theoretical view is the USTA study, which argues that prices will increase in the non-TELCO segment of the economy. Such different theoretical constructs illustrate dramatically the arbitrariness upon which the LECs are stating their cases. Also, neither study attempts to statistically quantify the interrelationships among different sectors of the economy, but instead uses either a purely theoretical approach (NERA) or the "a la carte" parameter approach (USTA). Therefore, the estimates of double counting produced by these models is highly suspect.

The NERA study works from a general equilibrium model of the economy, however this model is not used as a predicting tool. Rather, it is used to arrive at theoretical conclusions. As such, the model is not estimated in the conventional manner to discover the quantitative relationships in the economy. Therefore, it remains a skeleton based on

²⁶NERA Study, p.12.

the assumptions of classical economics. The NERA study is encumbered by the assumptions of classical economics -- perfect competition in the market for goods, services, and all inputs to the production process, perfect information, and no transactions costs. It performs a tautology: prices are assumed to reflect economic costs, therefore any change that is purely accounting will by definition have absolutely no impact. This model is clearly too restrictive and assumes away the complexities of the real world. Such a structure is totally inappropriate for the analysis of the issue at hand, that is, the impact of an increase in labor costs driven by SFAS-106 on the GNP-PI.

On the other hand is the USTA study, which makes the opposite assumption, that SFAS-106 costs would affect the GNP-PI for both the regulated and unregulated sectors of the economy. In the USTA study, an assumed level of increased labor costs due to SFAS-106 is used to simulate the impact of SFAS-106 on the sector of the economy offering OPEBs. This effect then feeds through the economy, decreasing the demand for labor, and decreasing the wage rate. Rather than argue that prices in the unregulated markets reflect economic costs, USTA takes the opposite case and argues that all sectors would be affected by SFAS-106 costs.

Therefore, the Commission, and other interested parties are faced with the choice of which model of the economic structure of the United States is appropriate for determining the impacts of SFAS-106 on the GNP-PI. Clearly, such diametrically opposed models demonstrate the subjective nature of the analyses performed by the LECs in their pursuit of exogenous treatment for SFAS-106. If the Commission were to choose one model or the other as the appropriate method for determining double counting for the

GNP-PI effect of exogenous costs, it would be tantamount to anointing one model as an official tool for evaluating double counting in the exogenous cost context. MCI, however, demonstrates herein, that neither model is appropriate for the determination of the amount of double counting in the GNP-PI, and therefore the LECs have not borne their burden of proof in demonstrating they will be inordinately harmed if not granted exogenous treatment.

NEITHER STUDY ADDRESSES THE LOW-END ADJUSTMENT FORMULA

Within their submissions, the price cap LECs generally dismiss the low-end adjustment formula as a relevant issue in the treatment of SFAS-106 costs. Also, neither the USTA study nor the NERA study grants any attention to this portion of price cap regulation. This is a key omission, because the low-end adjustment formula would serve as an adequate transitioning mechanism if price cap LECs do not receive exogenous treatment.

If SFAS-106 is recognized by the Commission as simply a new accounting treatment for a portion of the total labor compensation package, rather than affording it some type of special exogenous treatment, LEC earnings might be negatively affected to some extent in the first year of the accounting transition.²⁷ The existence of the low-end adjustment will serve as a backstop for LEC earnings in the first year or two of the FASB ruling as the LECs attempt to minimize the cost impacts of SFAS-106. During this time, for example,

²⁷MCI is unable to determine to what extent carriers' earnings might fall into the low-end adjustment mark. The level of detail as filed by the LECs is inadequate to determine the actual earnings impact of SFAS-106 on these carriers. Moreover, if carriers do not face an ability to make an automatic pass-through of these costs, they might attempt to gain efficiencies and reduce the negative impact of these costs.

carriers might hold the line or reduce their cash wage offers, prepare programs that serve to minimize their postretirement medical costs, or change their OPEBs to be more in line with those offered by corporations in more competitive segments. The low end adjustment formula will protect the LECs from inordinately sharp drops in earnings, and offer them the opportunity to implement these cost savings/earnings enhancement measures.

This protection offered by the low end adjustment mechanism is more than generous for this purpose. Because SFAS-106 is merely an accounting change, the basic integrity of the LEC businesses will remain unchanged. Simply put, SFAS-106 will recognize a liability, but there will be an offsetting increase in assets through the funding of the OPEBs. While earnings on paper would erode by some small amount, the actual financial viability of the LECs will remain strong. Use of the low end adjustment, rather than generating a rate increase through exogenous treatment, will also maintain the integrity of the price cap program. If the LECs are granted a rate increase through exogenous treatment every time the going gets a little tough, the price cap program will degenerate into a "heads we win, tails you lose" program for the LECs, just as MCI has warned.

ISSUES WITH THE USTA STUDY

The methodology employed within the USTA study is fatally flawed, and cannot possibly be used as a tool to prove the cost impacts of SFAS-106. The study attempts to derive what the impact would be on GNP-PI of SFAS-106, but it performs this in such an indirect and incorrect fashion as to be unreliable.

In essence, the study uses LEC data on OPEB plans, as well as a limited survey on OPEB plans offered by non-LEC firms. The study arrives at benefit level indicators for the two cohort groups. These benefit level indicators are assumed to serve as proxies for the costs associated with SFAS-106. Through a series of actuarial computations and back of the envelop adjustments, the study arrives at the "conclusion" that LEC labor costs would increase by 6.29%, while non-LEC firms would exhibit a 3% increase in labor costs. The 3% increase in labor costs is then plugged into a simplistic macroeconomic model to determine the supposed impact on GNP-PI.

The approach used within this study is disturbing. The ultimate result reported in the study, that the GNP-PI would reflect virtually none of the increase due to SFAS-106 costs, is based upon a comparison of benefit payout ratios. In no place within the study is there an attempt to verify the costs of SFAS-106 to non-LEC firms, other than through this benefit level indicator ratio. This ratio is the sole method used to derive the "fact" that labor costs would increase by 3.19% in the non-LEC sector of the economy.

The 3.19% increase in labor costs to non-LEC firms providing OPEB does not square with other estimates of the SFAS-106 costs. For example, the U.S. Department of Commerce reported that for 1990, Wage and Salary Disbursements for the United States were \$2,705.3 billion.²⁸ The USTA study maintains that only 32% of the economy is covered by OPEBs that will be affected by SFAS-106.²⁹ Therefore, according to the USTA

²⁸United States Department of Commerce News, Personal Income and Outlays: September 1991, Released October 30, 1991.

²⁹USTA Report, p.24.

report, SFAS-106 costs should total \$27 billion for the non-LEC firms.³⁰ This amount is only 40% of the estimates by Warshawsky.³¹ In fact, the USTA study uses no independent estimate of the yearly costs associated with SFAS-106 for either the annual accrual of expenses in any given year or the underfunded liability associated with prior year liabilities. Also, the USTA study uses data from only one insurance company to arrive at the cost of medical claims for the calculation of the nationwide Benefit Level Indicator.³² Given the wide variation in the difference between the USTA study costs, and other estimates of the costs of SFAS-106, it would be virtually impossible to apply the USTA methodology to ascertain the level of double counting in the GNP-PI.

¶ 13. (5) what type and level of SFAS-106 type expense is reflected in current rates;

See response to ¶ 13. (6) below.

¶ 13. (6) what type and level of SFAS-106 type expense was reflected in the starting rates for price caps;

As discussed fully above, the filing LECs refuse to acknowledge that the starting rates for price caps include any adjustments for SFAS-106 costs, excluding any amounts of pre-funded OPEBs. MCI presents evidence in its response above that directly contradicts

³⁰ $.0319 * .32 * 2,705.3 = 27.6$

³¹Mark Warshawsky, Postretirement Health Benefit Plans: Costs and Liabilities for Private Employees, No. 76, Finance and Economics Discussion Series, Division of Research and Statistics, Division of Monetary Affairs, Federal Reserve Board, Washington D.C., June 1989.

³²USTA Study, p. 15.

this position and shows that the LECs have been compensated for SFAS-106 through their authorized rate of return.

¶ 14. Descriptions and justifications of the actuarial assumptions, and the assumptions unique to postretirement health care benefits, made in computing the SFAS-106 expenses. These assumptions should include, but are not limited to, the time value of money, participation rates, retirement age, per capita claims costs by age, health care cost trend rates, Medicare reimbursement rates, salary progression (if a company has a pay related plan), and the probability of payment (turnover, dependency status, mortality, etc.) Parties and commenters should also discuss what assumptions, if any, were made about future events such as capping or elimination of benefits, or the possible advent of national health insurance.

MCI is concerned that the wide variety of values employed for the actuarial assumptions, as well as the somewhat dated nature of the turnover tables, cast doubt on the accuracy of the LEC estimates. There is no particular reason, for example, why there should be such a range of estimates as to the discount rate employed, the assumed return on plan assets, or the future inflation rate of medical care claims.³³

Moreover, some of the assumptions seem to have been chosen quite arbitrarily, in an effort to maximize the expected exogenous cost flow through. For example, the actuarial estimates provided by the LECs require assumptions concerning labor turnover rates. If the labor force has more frequent turnover, the implied liability for OPEBs is decreased, since these workers leave the LEC before having a claim on these benefits. Within its Direct

³³The variety of actuarial assumptions across LECs also impacts the estimates of double counting in the GNP-PI used by those LECs that concur in the USTA study. Within the USTA study, the estimate of the double counting within the GNP-PI is based on actuarial values calculated from a "composite" LEC. Therefore the estimate of double counting is only appropriate for that composite company. The individual LECs have filed within their Direct Cases the same estimate of double counting, and have all reduced their estimates of the exogenous cost flow through by 15.2 percent. This value would only be correct for those LECs that have identical matches to the actuarial and OPEB data used within the composite TELCO in the USTA study. Those LECs that deviate from the composite will therefore be incorrectly calculating the GNP-PI double counting. Nowhere in their Direct Cases do the LECs demonstrate that their Benefit Level Indicator Ratio is identical to that used by USTA for the composite TELCO.

Case, SNET uses data from the period of the mid-1970's on the separation rates of its employees to calculate its liability.³⁴ Clearly the structure of employment, both in the US economy and within the telecommunications sector, has changed dramatically since that time. Employees do not exhibit the same longevity with one employer as they did during that historical time, and the telecommunications sector in general has been marked by dramatic structural changes -- and less employment security -- since the mid 1970's. Therefore, it is mistaken for the LECs to rely on outdated information to obtain their liability estimates.³⁵

Such differences in assumptions can drive large increases in the SFAS-106 costs, because of the nature of discounting these liabilities over large spans of time. For example, the NYNEX estimate of its SFAS-106 costs ranges from \$45 million to \$101 million, depending on an assumption regarding the rate of health care cost inflation. This difference of 124 percent clearly indicates that a change in a single assumption can drive dramatic differences in the estimate of the SFAS-106 liability. The arbitrariness of these assumptions, as well as the methodological problems contained in footnote 33 above, clearly illustrate the need for the Commission to set uniform and auditable standards in

³⁴SNET Direct Case, Exhibit 4, pp.12-15. In many of the other Direct Cases, the source and vintage of the actuarial assumptions is not reported.

³⁵Within the USTA study, in its flawed attempt to estimate relative benefit ratio levels, the consultant utilizes turnover rates that are markedly lower than the average turnover rate. [USTA Study, p.48.] This results in inflated estimates of the OPEB liability. Like most of the assumptions made by USTA, the grounds for this are unsupported. USTA remarks that it chose this estimate because of the historical patterns of longer service life and higher average age for TELCO employees versus other employees. Unfortunately, the study does not indicate what time frame was used for this comparison, or whether the experience of the last few years, with the large amount of downsizing exhibited by the TELCO firms, has been included.

calculating the SFAS-106 costs if these costs are deemed exogenous in whole or part by the Commission.

¶ 15. Further, since part of the growth in the GNP-PI presumably occurs due to growth in medical costs, we seek information on what adjustment, if any, should be made in the exogenous adjustment to avoid any double counting. If any adjustment has been made, parties and commenters should document how the adjustment was computed. Moreover, parties and commenters should describe and quantify any wage changes which will be reflected in the GNP-PI that are expected to occur as a result of the introduction of SFAS-106. In particular, parties and commenters should discuss what adjustment, if any, should be reflected in the exogenous adjustment for this change.

The LECs, in their Direct Cases, dismiss the issue, raised by the Commission in its Order, directing the LECs to address the double-counting of medical care cost inflation in both the SFAS-106 costs as proposed by the LECs and the GNP-PI. For example, Rochester discounts the need for any adjustment, remarking that the calculation of its adjustment to costs merely places it in the same position had it been permitted to use accrual accounting in the first instance.³⁶ Bell Atlantic brushes off the issue with one sentence, indicating no further adjustments are necessary.³⁷ Other LECs make similar claims.³⁸ Apparently, the price cap LECs seem to be refraining from viewing the double-counting issue with anything less than double vision.

³⁶RTC Direct Case, p. 23.

³⁷BAT Direct Case, p. 27.

³⁸BST Direct Case, p. 20., Ameritech Direct Case, p. 22., SWB Direct Case, p. 30.

Currently, the LECs' costs reflect pay-as-you-go costs for OPEBs.³⁹ These costs have been covered by current revenues, revenues that will be allowed to grow with the GNP-PI. Absent any treatment of SFAS-106 costs, the revenues will grow, and any medical cost inflation that is embedded in the GNP-PI will be reflected in the growth of the revenues. Now, if one were to include SFAS-106 costs through exogenous treatment, the revenues resulting from the increase in the price cap index to account for those costs would also increase each year by the GNP-PI, as adjusted for the productivity factor.

The problem is that the SFAS-106 costs have already been adjusted for future inflation. As described in the LEC Direct Cases, the quantitative impact of SFAS-106 begins with the current claims costs of retirees, both pre- and post-65 years of age. This average claims cost is then factored to grow by the companies' assumptions regarding medical care inflation. The total claims for all future-expected retirees is then summed to arrive at the total SFAS-106 future pay-out. Therefore, the impact of medical care cost inflation has already been counted. As such, the amount offered by the LECs has been inflated to reflect future medical costs. To include these costs again within the price cap formula through exogenous treatment, and treat them by the full amount of GNP-PI, which has medical cost inflation embedded as well, is tantamount to double counting the medical care inflation rate.

Much of the confusion on the part of the price cap LECs stems from the fact that the actuarial directions of SFAS-106 do not consider the firm which has automatic increases

³⁹The following analysis, for simplicity, abstracts from MCI's contention that a certain amount of SFAS-106 costs have been built in to the authorized rate of return. Its abstraction does not limit the analysis, rather, the inclusion of that amount would only increase the amount of double counting.

in its revenue stream tied to the GNP-PI. In the case of a typical firm, whose prices are determined by various elements of supply and demand, and which may not have future expected price increases, it would be appropriate to follow directly the SFAS-106 requirements. However, the case of the price cap LECs is different. If the Commission does decide to afford these LECs exogenous treatment for SFAS-106 costs, this double counting must be eliminated. This can be accomplished either through the removal of medical care inflation from the GNP-PI, or through the removal of medical care inflation from the SFAS-106 accruals.

¶ 16. Finally, parties and commenters, relying on the macroeconomic model used in the USTA study should fully describe and document the model, including a method of estimation, parameter estimates, and summary statistics. This same data should be submitted for any alternate functional forms which were modeled, including data used to estimate the model, the data used in making forecasts from the model, and the results of any sensitivity analyses performed to determine the effect of using different assumptions.

In response to this section of the Order, all LECs utilizing the USTA study provided a paper written by USTA's consultant that constructed the model employed. From the original USTA model and the subsequent elaboration, it becomes clear that the model is not a true econometric forecasting model, but rather a theoretical construct that employs assumed relationships and user-provided parameters to perform "what-if" analyses. Such a model, in its final form, is nothing more than a somewhat advanced spreadsheet model. The purveyor of the model has selected a set of assumptions, relationships, and complexity within a mathematical framework, and has altered one assumption (labor costs) to arrive at a "what-if" analysis. This cannot be viewed as an objective forecasting tool, but rather as a means to legitimize overly simplistic calculations.

USTA readily admits that this is not a forecasting model, and attempts to argue the case that a true forecasting model would not be useful. It claims that the model is designed to indicate the differential impact on a certain level of GNP-PI if labor costs are increased.⁴⁰ Unfortunately, the Commission, and access ratepayers, are attempting to evaluate a forecasting question: To what extent would SFAS-106 costs be passed on to higher prices in the economy? The proposed model that attempts to answer that question is simply inadequate for the purposes of this proceeding, and its results cannot be relied upon to evaluate the LECs' contentions. USTA contends that the model, while not being useful for forecasting macroeconomic activity, can somehow be used for forecasting the differences in macroeconomic activity depending on a shift in an exogenous variable (the multiplicative term used to adjust labor costs for the SFAS-106 impacts).⁴¹ This distinction is artificial -- if a model cannot be relied upon to forecast the interactions within the economy, how can it be utilized to predict the differences due to some alteration to one value within the model?

The USTA model utilized suffers from other shortfalls as well. The USTA model is based on all the assumptions of a general equilibrium economic model: perfect competition in all markets for labor, capital, and goods, perfect information, no transactions costs, perfect substitutability of capital and labor, etc. While these assumptions may be required to construct such a model, they produce a tool that is simply at odds with the real world.

⁴⁰Response to Paragraph 16 of FCC Order of Investigation and Suspension, CC Docket No. 92-101, May 26, 1992, USTA Report, p. 7.

⁴¹MCI has already addressed its concerns about the weakness of the inputs to this model that drive the estimates of the SFAS-106 impact on the GNP-PI.

Furthermore, the model recognizes only two sectors (OPEB and Non-OPEB); it has no international sector; it utilizes global assumptions of the elasticities of demand, labor supply, and input substitution. Finally, although the model is attempting to review a dynamic phenomenon, the structure of the model is static in form. Such properties create a doubt as to the ability of the model to predict price behavior across numerous market segments that reflect various levels of competition, imperfect substitution of inputs, and varying degrees of demand and supply elasticities. It is clear from the discussion provided by the LECs and the points covered by MCI above that the model in question cannot be relied upon to evaluate the impact of SFAS-106 on GNP-PI.

CONCLUSION

Herein MCI has shown that the issue of SFAS-106 is clearly more complicated than indicated by the LECs' Direct Cases. In particular, MCI demonstrates that the LECs have not adequately addressed the double counting that is inherent in the current rate of return, nor have the LECs accounted for the double counting within the GNP-PI and the medical care cost inflation embedded in the SFAS-106 cost estimations. Further, the LECs own methodologies suffer from fatal flaws that preclude their use in determining the amount of double counting in the GNP-PI term in the price cap formula. Also, the level of detail provided by the LECs is inadequate to ascertain the reasonableness of the proposed costs and the resulting rate increase.

More importantly, however, is the issue of whether SFAS-106 costs can be considered exogenous. MCI has shown the simultaneity of benefit costs and wage costs

and concludes that exogenous treatment for SFAS-106 costs would not be workable nor desirable. To afford one cost exogenous treatment, while keeping endogenous treatment for another, would allow LECs to game the system, and disrupt the incentives built into the price cap program. Therefore, MCI urges the Commission to refuse exogenous treatment for SFAS-106 costs for the price cap LECs.

Respectfully submitted,

MCI TELECOMMUNICATIONS CORPORATION

A handwritten signature in black ink, reading "Michael F. Hydock". The signature is written in a cursive, flowing style.

Michael F. Hydock
Senior Staff Member
1801 Pennsylvania Ave. NW
Washington, DC 20006
(202) 887-2731

Dated: July 1, 1992

STATEMENT OF VERIFICATION

I have read the foregoing, and to the best of my knowledge, information, and belief there is good ground to support it, and that it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on July 1, 1992.

A handwritten signature in cursive script, reading "Michael F. Hydock". The signature is written in black ink and is positioned above a horizontal line.

Michael F. Hydock
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CERTIFICATE OF SERVICE

I, Charisse Raysor, do hereby certify that copies of the foregoing MCI Filing were sent via first class mail, postage paid, to the following on this 1st day of July, 1992:

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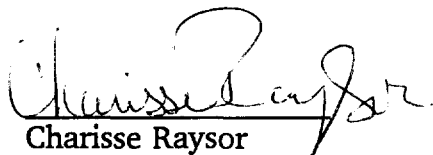
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Hand Delivered**


Charisse Raysor

APPENDIX

A

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC

In the Matter of

Treatment of Local Exchange
Carrier Tariffs Implementing
Statement of Financial Accounting
Standards, "Employers Accounting
for "Postretirement Benefits Other
Than Pensions"

Bell Atlantic Tariff F.C.C. No. 1

US West Communications, Inc. Tariff
F.C.C. Nos. 1 and 4

Pacific Bell Tariff F.C.C. No. 128

CC Docket No. 92-101

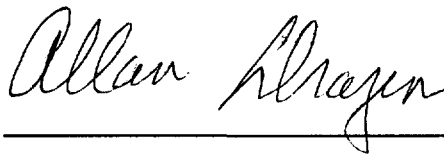
Transmittal No. 497

Transmittal No. 246

Transmittal No. 1579

VERIFICATION

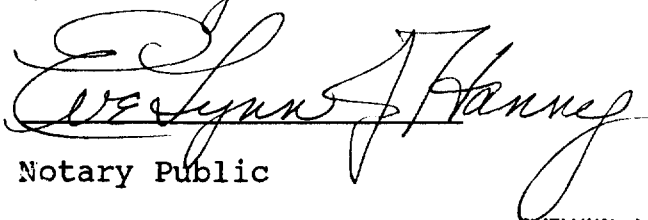
I, Allan Drazen, affirm that the foregoing Statement of Dr. Allan Drazen In Support of the Opposition to Direct Cases in the above-captioned docket was prepared under my direction and supervision and that it is true to the best of my knowledge and belief.



Allan Drazen

Sworn to before me this

9 day of June, 1992



Notary Public

EVELYNN J. HANNY.

Notary Public, District of Columbia

My Commission Expires May 14, 1995

1. My name is Allan Drazen. I am a Professor of Economics at the University of Maryland, since August of 1990. I received an S.B. in Economics from the Massachusetts Institute of Technology in 1972 and a Ph.D. from MIT in 1976, specializing in macroeconomics and monetary economics. I have previously taught at the Graduate School of Business at the University of Chicago, Tel-Aviv University, the University of Pennsylvania, and Princeton University, where I was visiting Professor of Economics from September 1988 to August 1990. I currently teach Macroeconomics, Monetary Economics, and International Finance, courses I have taught in my other appointments as well. I also taught Public Finance for Public and Non-Profit Enterprises at the University of Chicago.

2. In this and other proceedings, the Commission has indicated its concern that rates be set to provide a fair rate of return. The basic question in this proceeding is whether the existing rate structure adequately compensates the price cap local exchange carriers ("LEC"s) for the cost changes resulting from adoption of SFAS 106. The price cap LECs have argued that the changes required under SFAS 106 satisfy the condition for an exogenous cost change that are required for a change in the Price Cap and that an increase in the Price Cap is required to insure a fair rate of return. MCI Communications Corporation has asked me to analyze the arguments presented in the price cap LECs filings and the supporting documents to this effect. I conclude that the arguments they present do not support their request and that, in fact, the adjustment they request would most probably lead to an overcompensation of investors, that is to a "double counting" of the cost effects of SFAS 106.

3. Most of the price cap LECs requests are based on a study by USTA on the effect of SFAS 106 on costs of a typical LEC. The USTA study constructs a hypothetical carrier ("TELCO") and argues that SFAS-106 disproportionately affects TELCO, with the average company in the U.S. experiencing only 28.3 % of the cost increase which TELCO experiences due to SFAS 106; USTA further argues that the expected increase in overall U.S. price level and the expected decrease in the average wage level will make up only 14.5% of this differential impact. In the absence of a rate increase, it is therefore argued, the sharp increase in costs relative to other companies will unfairly reduce the rate of return to capital for those carriers most affected by SFAS-106.

4. The conclusion is flawed, in that it ignores two effects: first, the effect that the anticipated adoption of SFAS 106 may already have had on the price of the LECs' stock and hence on the rate of return to capital on which current rates are based; and, second, the effect of future actions by the LECs or the government to offset the effect of SFAS 106. An increase in the market rate of return in anticipation of SFAS 106 will mean that a rate increase when SFAS 106 is actually adopted will result in investors being doubly compensated for its effects. Offsetting future actions will mean that calculations which ignore such offsets will further overcompensate the LECs.

5. Consider first the overcompensation via adjustment of stock prices. To see how double compensation comes about, one may examine the implications of an efficient capital market in asset pricing. Efficient markets theory argues that a future anticipated change

in cost and hence earnings will be reflected in current stock prices. Suppose, for example, that change in government regulations increases costs and reduces profitability (as is argued for SFAS 106). To the extent that the market anticipates a possible future change in regulations that is not reflected in current earnings or cash flows, the stock price of a company whose earnings are expected to be strongly affected will fall relative to those companies whose costs will be less affected. Put equivalently, the rate of return earned by investors in such companies will rise relative to the market rate of return, to compensate them for the expected future drop in the company's earnings. With well-functioning capital markets the adjustment in rates of return ex ante means that the fact that future earnings will be low is of no consequence in itself to an investor.

6. The use of the Discounted Cash Flow method to calculate the cost of equity " K_e " reflects exactly such an effect of anticipated future events in a well-functioning capital market. When the current dividend is unaffected by the anticipation of a possible drop in future earnings or by higher uncertainty about future earnings, a fall in the price of a stock will increase the dividend yield D/P and hence the cost of equity in such a way to compensate investors for the expected earnings change before the fact. The cost of equity calculated by the DCF formula is the sum of the dividend yield and an estimate of the long-term growth in dividends G . A future regulation such as SFAS 106, which is anticipated to induce a discrete downward adjustment in accounting profits when first adopted but whose exact initial impact is uncertain, should have a clear effect in reducing the stock price but a far less clear effect on estimates of G . Hence, in theory, one's strong

presumption is that when there is agreement on the direction of the effect of a regulation on profitability, but uncertainty about its exact impact before it is adopted, there will be a fall in the stock price, and hence an increase the yield and in the cost of equity as measured by the DCF formula before the regulation is adopted.

7. The possibility that an anticipated future cost increase will be reflected in a higher current cost of equity is noncontroversial in theory. Whether the anticipated adoption of SFAS 106 might be adopted in fact had the effect that theory suggests is an empirical question. Mark J. Warshawsky of the Board of Governors of the Federal Reserve System has studied both the effect of SFAS 106 on expected costs and profits of firms offering retirement health benefit plans⁴² and the effect of the increased liabilities implied by SFAS 106 on stock prices.⁴³

In the first paper, Warshawsky's findings parallel those of the USTA study. Had the changes been adopted in 1988, the expenses, calculated on an accrual basis, would have been \$67.9 billion, or over 20 percent of reported corporate profits. As in the USTA study of telephone companies, Warshawsky finds that companies hardest hit would be those where post-retirement health benefit plans are most extensive.

⁴²Mark J. Warshawsky, "Postretirement Health Benefit Plans: Costs and Liabilities for Private Employers", Finance and Economics Discussion Series paper 76, Division of Monetary Affairs, Federal Reserve Board, Washington, D.C., June 1989.

⁴³Mark J. Warshawsky, "The Impact of Liabilities for Retiree Health Benefits on Share Prices" Finance and Economics Discussion Series paper 156, Division of Monetary Affairs, Federal Reserve Board, Washington, D.C., April 1991.